PALOS

CONTENTS

Oil Prices Continue to Surge	1
Palos Funds vs. Benchmarks (Total Returns)	3
Disclaimer & Contacts	4

Weekly Commentary

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By Charles Marleau CIM® and William Mitchell CIM®

Oil Prices Continue to Surge

Finally, a welcome break from the heat! We are back from our summer break and we're eager to resume our weekly newsletters which are intended to be informational, educational and timely. In our last edition prior to our summer break (Issue no. 28, July 10) we noted that oil prices had dropped by roughly 30% since peaking in June 2022. This was good news for consumers, travellers, and shippers alike. Falling oil prices are disinflationary as lower fuel costs ultimately transition to lower prices for consumers and businesses. However, the picture has changed dramatically since the end of June.

The most widely followed crude oil benchmarks are the North American based West Texas Intermediate (WTI) futures contracts which trade on the New York Mercantile Exchange (NYMEX) and the European focused ICE Brent Crude futures that trade on the Intercontinental Exchange (ICE). Both trade in U.S. dollars. As of last Friday's close, WTI prices had risen by 24% to $87.51/boe over the past eleven weeks. Brent closed at $90.65/boe and is higher by 21% over the same time frame. In general, Brent trades at a slightly higher price than WTI (the "spread") with the difference attributed to grade or specification differences, and regional variations in supply or demand. Other contracts, although less followed, include Urals Oil, Dubai Crude and Western Canadian Select (WCS).

Several factors are driving the rise in prices. The supply/demand curve is well understood and with regards to oil, it's the supply side of the equation that's the main culprit. The Organization of the Petroleum Exporting Countries (OPEC), in tandem with Russian production, form a producing bloc called OPEC+ that accounts for roughly 40% of global production. Just last week, key OPEC+ members Saudi Arabia and Russia announced additional production cuts that would extend through the end of 2024; this on the heels of initial production cuts of one million barrels per day announced by Saudi officials in June. The desired objective is to drive global prices higher.

Some of the rationale for the production cuts are related to softening economic activity in China. Many economists believed that a reopening of the Chinese economy, once zero-Covid policies were removed, would drive global oil consumption higher. However, the "numbers" are suggesting that expectations for increased Chinese demand may have been overly optimistic as China's economy continues to show signs of

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slowing. Further, western sanctions on Russin oil exports appear to have had little impact on Russian exports; China and India are quite happy to purchase "cheap oil" while they can.

There are supply-related factors on this side of the Atlantic. The Baker-Hughes Rig Count ("rig counts") measures the number of drilling rigs that are actively operating in the Unites States and Canada. Rig counts are a widely followed measuring stick for future oil and gas demand. This is based on the simple rationale that a rise in rig counts (i.e., increased drilling activity) suggests that producers have confidence in rising demand and are prepared to invest accordingly. Falling rig counts imply the opposite. In a recent report from Desjardins, oil rigs fell by 13% on an annualized basis (down 129 rigs as of this August 2023). Falling rig counts ultimately imply a reduction in supply, thus higher prices, looking forward.

The good news is that investors in the Canadian oil patch are seeing a sector-wide boost in share prices following a sluggish start to the year. Canada's three largest producers, as measured by market capitalization, are **Canadian Natural Resources Ltd. (CNQ: TSX, NYSE), Suncor Energy (SU: TSX, NYSE)** and **Cenovus Energy (CVE: TSX, NYSE)** whose share prices have increased by 19.0%, 20.5%, and 24.0% respectively since June 30. In fact, CNQ traded at an all-time high on Friday. Mid-tier Canadian operators like **Arc Resources (ARX:TSX), Tourmaline Oil (TOU: TSX), MEG Energy (MEG:TSX)** have seen similarly impressive gains of 19.2%, 12.1%, and 20.5% since June 30. Accompanying higher crude prices are significantly rising cash flows, which has strengthened balance sheets via reduced debt levels, and hence the fulfilment of promises to increase distributions to shareholders through dividend increases and share buybacks.

We continue to have a positive view on the Canadian energy sector given the constructive oil demand set up, strengthening financial fundamentals, and a stated objective of many operators to prioritize shareholder returns over capital investment. Presently, **The Palos Income Fund, The Palos Equity Income Fund** and **The Palos-Mitchell Alpha Fund** hold investments in ARC Energy, Canadian Natural and Tourmaline. The Alpha Fund also holds shares in Suncor, Cenovus, and MEG Energy.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.34	6.07%
Palos Equity Income Fund - RRSP	PAL101	$6.78	4.96%
Palos WP Growth Fund - RRSP	PAL213	$10.68	-14.16%
Palos-Mitchell Alpha Fund [3]	PAL300	$10.71	35.38%
S&P TSX Composite (Total Return with dividends reinvested)			5.91%
S&P 500 (Total Return with dividends reinvested)			17.43%
S&P TSX Venture (Total Return with dividends reinvested)			2.05%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			4.26%
Canadian Government 10-Year			3.68%
Crude Oil Spot			US $87.51
Gold Spot			US $1,924.60
US Gov't10-Year/Moody BAA Corp. Spread			184 bps
USD/CAD Exchange Rate Spot			US $0.7331

[1] *Period ending September 8rh, 2023. Data extracted from Bloomberg*

[2] *Fund is priced annually*

[3] *Fund is priced weekly on Tuesdays*

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Disclaimer:

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

4711 Yonge Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 343-7772

www.palos.ca